Showing Signs of Growth? Implementing Reforms.

by Vincenzo Guzzo, IMF Resident Representative for Cyprus

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Thank you for inviting me to this important event. It is a real pleasure to be here today and I appreciate the opportunity to say a few words about the recent progress of the Cypriot economy and some of the challenges going forward.

Some recent action, or rather inaction, could be perceived as an indication that the need for implementing reforms is not as strong any longer given the early signs of growth in the Cypriot economy. Let me say upfront that such positions have no foundations. Implementing reforms is important.

I will spend the first half of this presentation trying to convince you that signs of growth are indeed emerging. I will then turn to describing some of the structural challenges we are confronted with, notwithstanding these positive conjunctural developments. I will conclude by stressing the critical role of reforms in addressing these challenges and by identifying a few key policy priorities for Cyprus.

Growth momentum is significant

Cyprus has delivered an impressive turnaround during the past few years. After a cumulative contraction of over 10 percentage points between 2012 and 2014, the economy has returned to growth last year and has accelerated further in 2016, well beyond expectations. We see GDP growing by 2.8 percent this year, with risks still skewed to the upside. Tourism and professional services have been the main engines of the recovery, but the expansion in economic activity has been broad-based across all sectors.

The chart on the right hand side (of the second slide) shows significant progress in repairing the macroeconomic damage caused by the crisis. The vertical bars measure the percentage deviations of IMF staff GDP estimates for 2016 from their levels in 2007, ahead of the global financial crisis. The chart suggests that by the end of this year Cyprus will have recovered quite a bit of the ground lost during the crisis. This is better than other Southern European countries which had not experienced as deep recessions as Cyprus and it is an indication of significant growth momentum.

Cyprus has not caught up with its pre-crisis trend growth. The black dot on the same chart says that we are still well below the trend emerged between 1996 and 2005. However, we should look at this last comparison with caution. We know that back then growth was rooted in major imbalances and proved unsustainable.

Jobs are being created

The labor market is also showing early signs of recovery. The unemployment has peaked at over 16 percent in late 2013, but it has fallen rapidly since then. Initially, a decline in the size of the labor force contributed to the decline in the unemployment rate. However, the labor force appears to have stabilized now and new jobs have led to a noticeable fall in the unemployment rate.

According to Eurostat, Cyprus reported the largest drop in the unemployment rate among all EMU members from a year earlier. Nevertheless, at over 12 percent, it remains high relative to other EMU countries as well as to Cyprus' recent history.

Let me now turn to the challenges.

Demographics are not favorable

With lower fertility rates, population growth in advanced economies has declined over the past decade and is projected to decline further over the next five years and beyond. So far, Cyprus has benefited from relatively strong demographics, but this trend may not be sustainable going forward.

In addition, the share of workers aged 55 to 64 has increased sizably.

Population aging will likely increase pressure on pension and health care systems, thus worsening the dynamics of the debt. Migration from emerging markets and developing economies may alleviate the impact of aging on the labor force. Cyprus did benefit from migration inflows over the past decade. However, as we know, receiving migrants also creates challenges, especially in a context of recovering economic growth.

Productivity is weak

A second important trend is weakening productivity growth. Again, this is not only a problem for Cyprus. The chart on the left hand side (of the fifth slide) shows a significant slowdown in labor productivity for a sample of countries in the region and, in fact, a similar pattern can be observed across all advanced economies.

The causes for the productivity slowdown remain uncertain. It may partly reflect a prolonged downward trend in investment. The second chart on this slide shows how the share of total investment for the same group of countries has nearly halved during the past decade. In turn, weak investment spending is a legacy of the financial crisis, as banks continue to struggle with a large amount of NPLs, holding back new lending and suppressing investment.

The combination of unfavorable demographics and weakening productivity may significantly constrain prospects of potential growth over the medium term. But expectations of lower future output growth may lead firms to further scale down investment, which in turn can take a toll on future potential output, leading to a vicious circle.

Policy priorities for Cyprus

As we are confronted with these major challenges, it is important that we continue to resort to structural reforms. Structural reforms play a critical role in ensuring that the recent positive conjunctural developments translate into structural, long-lasting growth, by helping create an environment which is conducive of stronger investment and productivity. Here are some key policy priorities for Cyprus:

i. Repair bank balance sheets addressing NPLs and strengthening operational efficiency to support new lending – In a country where NPLs are still 48 percent of all loan facilities, there should be no doubt about the number one policy priority. Addressing the NPL problem would allow banks to extend new lending to firms and families and to do that on better terms. Stronger operational efficiency could also improve banks' profitability and ultimately their ability to support the economy.

ii. Commit to credible medium-term fiscal consolidation to generate space for productive public investment – Controlling the growth of the public sector wage bill and increasing the efficiency of the civil service would contribute to ensuring a sustained downward path for public debt, which in turn would support economic growth, including through productive investment.

iii. Eliminate product and labor market distortions to ensure efficient allocation of factors of production – Privatizing state-owned enterprises would allow better and less expensive services for the population and would attract foreign direct investment, which in turn would bring jobs and increase liquidity in the economy.

iv. Promote policies that encourage investment in research and development and foster innovation to sustain long-term potential growth – Countering the decline in private and public investment would boost the potential growth of the country both directly through expanding production capacity (and replace obsolete one) and indirectly by upgrading the technological content of the existing stock of capital.

Conclusion
Let me conclude by saying that there is no quick fix to the economic crisis the country went through over the past few years. Only steady and resolute implementation of structural reforms along the path already started can ensure a sustained return to economic prosperity and jobs.

On the contrary, no reforms would mean a stalling scenario for the economy: low growth, high unemployment, a future that is going to offer much fewer opportunities to the new generations of young Cypriots. The cost of getting stuck in a no-reform scenario would be very high.

Most likely Cyprus will not go back to pre-crisis growth rates, and maybe it shouldn't! That growth was rooted in major imbalances and proved unsustainable. But targeted reforms can ensure a return to jobs, stability and prosperity.

Let me thank you for your attention. I am now available for any question you may have.